A Rating-Based Sovereign Credit Risk Model: Theory and Evidence*

Haitao Li†  Tao Li‡  and Xuewei Yang§

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Abstract

We develop a rating-based continuous-time model of sovereign credit risk with closed-form solutions for a wide range of credit derivatives. In our model, rating transition follows a continuous-time Markov chain, and countries with same credit rating share similar level of default risk. A parsimonious version of our model, with only 16 parameters, one common and one country-specific factor, can simultaneously capture the term structure of CDS spreads of 34 in-sample and 34 out-of-sample countries well. On average, the common factor explains more than 60% of the variations of the CDS spreads of both the in-sample and out-of-sample countries, and 80% of the variations of the common factor is explained by the CBOE VIX index, the 5-year US Treasury rate, and the CDX NA IG Index.

Keywords:  Credit Rating, Sovereign Credit Risk, Credit Default Swap, Systematic Risk

JEL Classification:  G22, G33


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†Cheung Kong Graduate School of Business, Beijing 100738, China, email: htli@ckgsb.edu.cn.
‡Department of Economics and Finance, City University of Hong Kong, Hong Kong, email: taoli96@gmail.com.
§School of Management and Engineering, Nanjing University, Nanjing 210093, China, email: xwyang@nju.edu.cn.